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Seirbhísí Airgeadais na hÉireann

Central Bank &
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Eurosystem

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Dear Minister

Following the practice established in previous years, I am writing to you at this time to put forward the views of the Board of the Central Bank and Financial Services Authority of Ireland (CBFSAI) on economic and financial developments in advance of the forthcoming Budget.

The economy is undergoing a marked slowdown this year in response to a sharp weakening in domestic demand and a deterioration in the external environment. The level of both GNP and GDP is set to contract this year, by around 1.4 and 0.8 per cent, respectively. While much of the slowdown reflects the sharp contraction of activity within the housing sector and the consequent impact this has had on the labour market, incomes, sentiment and consumer spending, these developments have been very significantly exacerbated by persisting and deepening systemic difficulties in international financial markets, which has led to serious financial market turbulence and a marked tightening of credit conditions. In addition, economic activity has also been affected by high commodity prices, an appreciating euro exchange rate and faltering growth in our main trading partners.

Looking ahead to 2009, economic weakness is expected to persist, with GDP and GNP both projected to decline at around a similar pace as in 2008. The unemployment rate is projected to increase significantly over the next year or so, mainly as a result of declining activity levels in the domestic economy and, in particular, in labour intensive sectors such as residential house building. Notwithstanding the weak outlook, some additional domestic and external risks to growth persist. The assumed levelling-off in housing output over the course of 2009 may be delayed if sentiment and confidence levels remain weak. On the external side, risks emanate from the fact that the domestic economy remains very susceptible to external shocks, given the high degree of openness in the economy. In particular, conditions in the US and UK markets have clear implications for both Irish exports and inward foreign direct investment, as a sustained slowdown in these countries has disproportionately large effects on Ireland relative to other euro area countries.

In the housing market, approximately 47,000 housing completions are projected by the Bank for this year, with a further moderation to about 25,000 units in 2009. The fall in housing output and in house prices reflects the effects of weak demand, tighter credit conditions, an overhang in supply due to excessive building in recent years and concerns that prices may still be overvalued. While the scale of the weakening in the housing sector has been greater than expected, the moderation in activity has long been seen as an inevitable development, since levels of house building had been unsustainably high and well above the economy's medium-term requirements. Similarly, the share of construction within the overall economy had risen to rates well above European averages, representing an unsustainable situation. In addition, in relation to house prices, there had been increasing evidence of overvaluation in the market in recent years. This overvaluation persisted for a sustained period of time and is estimated to have peaked in early 2007. Since then, prices have declined and are currently closer to, although still above, their medium-term equilibrium values.

There has been a notable pick-up in inflation over the past year. HICP inflation is likely to average 3.3 per cent in 2008 before falling back to 1.6 per cent in 2009. Much of the pick-up in inflation in 2008 reflected higher commodity prices, particularly for food and oil, over which Ireland, as a price taker on international markets, has no control. The projected moderation in inflation over the next year reflects the impact of the easing of food and energy prices and the weakening in the economic environment. However, domestically generated inflation, particularly in the services area remains high and contrasts with the relatively muted price pressures in the non-energy goods sector. This has clear implications for the overall level of competitiveness, particularly as Ireland has the highest price level in the euro area in terms of goods and the second highest in terms of services, with prices significantly ahead of euro area averages. Given the already high price level in Ireland, it is important that the Budget does not add appreciably to inflation. A period of lower than average inflation in Ireland relative to the euro area is necessary to restore previous competitiveness losses.

In addition to the relatively high rate of consumer price inflation in Ireland, the economy has suffered competitiveness losses arising from both the strong appreciation of the euro and relatively high increases in labour and non-labour costs. Labour cost competitiveness has deteriorated relative to our main trading partners in recent years as a result of robust earnings growth coupled with only modest gains in productivity. Non-labour costs in Ireland are also quite high relative to our European counterparts in a range of areas; this highlights the need for increased levels of competition within the sheltered sectors and network industries, as was also recognised by the OECD earlier this year.

Turning to the Government finances, the outturn for the General Government Balance in 2008 is set to exceed, perhaps significantly, the 3 per cent Stability and Growth Pact deficit limit. While this has occurred against the background of an exceptionally sharp slowdown in growth, the size and speed at which the public finances have moved from a position of surplus to deficit gives cause for serious concern. It is clear that the Government shares these concerns, given the measures announced in July and the decision to bring forward the 2009 Budget. The quick recognition of the problem and the decision to act are to be commended. In particular, I welcome the measures announced by your Department last July on the current expenditure side. Similarly, the review of state agencies should help to achieve efficiency gains as well as alleviating current spending pressures, since there will be increasing demands placed on social expenditure. In the light of the further deterioration in the public finances in recent months, it is critical that the Government continues along this path and takes further significant corrective action to rein in the deficit in a timely and credible manner.

The formation of the upcoming Budget will be more challenging than in previous years, given the changed economic climate. In such circumstances, it would be appropriate to allow the automatic stabilisers to work, but pressure to take significant expansionary fiscal measures beyond that should be resisted. There are a number of reasons for doing this. Firstly, both our own experience and that of others is that it is easier to correct imbalances if action is taken early. Secondly, the Government has built up a strong reputation for pursuing prudent fiscal policies in recent decades, and as a country we have benefited enormously from this reputation, helping us to attract FDI and facilitate growth. Running high deficits at this juncture could damage this reputation. Thirdly, large deficits can impact negatively on long-term economic growth and give rise to high tax burdens in future years. In addition, the fact that Ireland is a small open economy would mean that a significant portion of any fiscal stimulus would inevitably flow out of the economy.

The path of recovery will be influenced by how we now respond to the current challenges we face. To create the conditions for a sustainable recovery back towards the potential growth path of the economy, it is vital that fiscal prudence be maintained and that the overall competitiveness position of the economy be improved. It is important that the upcoming Budget sends such signals clearly to the various stakeholders, both domestically and internationally.

Within the constraint of maintaining fiscal prudence, it will be necessary to carefully manage the allocation of scarce public funds and to focus on measures to increase the efficiency and effectiveness of Government spending, both current and capital. Given its weight in current spending, of just under 40 per cent, it is imperative that developments in public pay take account of the current constraints. In this regard, the inclusion of a significant public sector pay pause in the proposed new National Pay Agreement is to be welcomed.

A strong commitment to expenditure on those key infrastructural projects, which will enhance productivity and improve the potential for the economy to grow in the future, while at the same time limiting the rate of increase in current spending, will send a clear signal that sustainable growth in the medium-term remains the priority of economic and fiscal policy. In addition, in the light of the downturn in revenue, it may be timely to examine means of broadening the current relatively narrow revenue tax base in order to increase future income flows and also as a means of keeping overall tax rates low.

Some have argued that the scale of adjustment within the property market creates a case for Government intervention in this area. However, by international standards there are already considerable tax supports and incentives in place in relation to property, and considerable care needs to be exercised here. Policies that work against necessary, even if painful, market adjustments, ultimately delay recovery and hold back growth. It is important to allow market forces to work, so that house prices and output can adjust to sustainable levels.

The past year has been an exceptionally challenging and difficult one for the Irish economy due to the sharp slowdown in domestic demand, which has also been exacerbated by unfavourable developments on the external side of the economy. To achieve sustainable growth and higher living standards in the medium to long term, a renewed effort must be made to regain competitiveness losses, achieve efficiency gains and to generate stronger productivity growth so as to attract high value added foreign direct investment and to grow Irish exports. Clearly, competitiveness vis-à-vis our main trading partners must take priority, particularly as domestic demand, the principal source of growth through much of the past decade, moderates. This will require a further opening up of sheltered sectors of the economy to increased competition, a point that has been recognised by the OECD in its recent 2008 Survey of Ireland. Continuing high levels of capital investment will be needed to further ease infrastructural bottlenecks and constraints. That said, stringent cost benefit analysis must be applied to prioritise investment projects.

At the same time, the rate of increase in current spending remains a source of concern given domestic inflationary pressures, a narrowing tax base and a deteriorating General Government Balance, a point that was also recognised by both the IMF and the OECD in recent reports on Ireland. In light of this, it would be prudent and appropriate to limit the increase in current spending in order to arrest the decline in the headline Government balance. In general, future current expenditure plans need to be framed in a manner consistent with credible and sustainable revenue projections.

Finally, may I take this opportunity to wish you every success with the forthcoming Budget.

Yours sincerely